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In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 1159

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK, AS LIQUIDATOR OF MANHATTAN CASUALTY COMPANY, PETITIONER

v.

BANKERS LIFE AND CASUALTY COMPANY, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

OPINIONS BELOW

The opinion of the court of appeals (App. 97a) is reported at 430 F. 2d 355. The opinions of the district court (App. 50a, 89a) are reported at 300 F. Supp. 1083.

JURISDICTION

The judgment of the court of appeals was entered on July 22, 1970. A timely petition for rehearing

and suggestion of rehearing *en banc* were denied on September 30, 1970. The petition for a writ of certiorari was filed on December 24, 1970, and was granted on March 22, 1971. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

The Commission will discuss the following question: Whether Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b–5 thereunder provide a remedy for a corporate insider's fraudulent inducement of the board of directors of a corporation holding securities to sell those securities on the misrepresentation that the insider would invest the proceeds of the sale for the benfit of the corporation.

STATUTES AND RULES INVOLVED

Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), provides:

> 17. (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), provides:

10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b–5 promulgated by the Commission under the Securities Exchange Act of 1934, 17 CFR 240.10b–5, provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) To employ any device, scheme, or artifice to defraud,

(2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made,

in the light of the circumstances under which they were made, not misleading, or

(3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

STATEMENT

The court of appeals upheld a district court decision which dismissed a complaint for failure to state a cause of action under the federal securities laws. This action was brought by the Superintendent of Insurance of the State of New York, as Liquidator of Manhattan Casualty Company ("Manhattan").[1] Manhattan was a New York corporation engaged in the casualty insurance business and was wholly owned by, but under management separate from, defendant Bankers Life and Casualty Company ("Bankers Life") (App. 51a). The complaint alleges generally that each of the defendants was a participant in a scheme to defraud Manhattan in connection with certain sales of securities in violation of the federal securities laws (App. 7a, 13a). Although the complaint alleged violations of only Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), the lower

[1] N.Y. Ins. Law §§ 511, 513 (McKinney, 1966). Among other things, liquidation of a New York insurance company may be predicated on the insurer's insolvency. By operation of law, the superintendent is vested with the title to all of the property, contracts and rights of action of the insurer as of the date of the entry of the order of liquidation. N.Y. Ins. Law § 514(2) (McKinney, 1966).

courts also considered the applicability of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b–5 thereunder, 17 CFR 240.10b–5 (App. 6a–7a, 66a). See *Hoover* v. *Allen*, 241 F. Supp. 213, 226 n. 7 (S.D. N.Y.).

Specifically, the amended complaint[2] alleges that in January 1962, Bankers Life agreed to sell all the stock of Manhattan to two of the individual defendants in this action—Standish T. Bourne and James F. Begole[3]—for $5 million (App. 98a). The purchasers, however, did not pay for the Manhattan stock out of their own funds. Rather, with the aid of the other named defendants, they embarked upon a scheme to use Manhattan's own assets to pay for the purchase of its stock. Bourne and Begole caused Irving Trust Company, through one of its officers, to issue a check for $5 million on the morning of the closing, although they had no funds on deposit there to cover the check; on the same day, after securing control of Manhattan, they caused Manhattan to sell $5 million in United States Treasury bonds then in

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[2] For purposes of these proceedings, the complaint is considered as having been expanded by "amendatory allegations presented in open court" which were "not formally set forth in the complaint" (App. 104a). The motions to dismiss were made five years after the filing of the complaint, and intervening years of discovery were construed by the district court and the court of appeals as having augumented the complaint in the respects thus alleged.

[3] Both Bourne and Begole died prior to petitioner's appeal to the court of appeals; accordingly, they are no longer involved in the proceedings. More recently, another individual defendant, George K. Garvin, has also died.

its portfolio, and used the proceeds to cover the Irving Trust Company check.

Petitioner alleges, in effect, that, as part of the overall scheme, Manhattan's board of directors was deceived by some of the defendants into selling these bonds by the misrepresentation that "the sale of the bonds was intended only to effectuate a substitution of those assets for a certificate of deposit equal in value * * *" (App. 105a). A certificate of deposit for $5 million was obtained in Manhattan's name in a separate paper transaction, which did not involve any use of the bond-sale proceeds. This certificate was pledged at its creation as collateral for a $5 million loan in favor of an unrelated corporate entity, which in turn used that loan to pay for the issuance of the certificate. The certificate was thus in fact worthless to Manhattan,[4] although it was carried on Manhattan's books without showing its use as collateral, perpetuating the fraud by making it appear that the promise to the board of directors had been carried out (App. 105a). In sum, on the basis of the fraudulent representations made to Manhattan's board of directors, "the board was deceitfully induced to authorize the sale of the bonds in exchange for a certificate without value to the corporation" (App. 105a).[5]

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[4] Indeed, it has been held in a criminal trial of this matter under New York State Insurance law, N.Y. Ins. Law § 78(2) (McKinney, 1966), that "the certificates [of deposit] were never assets of Manhattan." *People* v. *Sweeny*, 27 N.Y. 2d 138, 148.

[5] The court recognized that the board of directors had been deceived: "No doubt the deception was successful, for had

On motion, the district court dismissed the complaint (App. 50a, 89a). The court of appeals affirmed (App. 97a). The affirmance rested in part on petitioner's lack of standing to challenge certain aspects of the fraudulent scheme—questions this Court left open in *Securities and Exchange Commission* v. *National Securities, Inc.*, 393 U.S. 453, 467, n. 9.[6] The

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the [Manhattan] board [of directors] known that [those in control of Manhattan] intended to misappropriate the proceeds for their own use it undoubtedly would not have authorized their sale" (App. 105a).

[6] The complaint alleges that three securities transactions, all part of the overall scheme, each violated Section 10(b), but seeks only a single recovery (App. 108a, n. 9). The court of appeals held that, under *Birnbaum* v. *Newport Steel Corp.*, 193 F. 2d 461, 463 (C.A. 2), certiorari denied, 343 U.S. 956, petitioner had no standing to challenge two of those transactions, but that he had standing to challenge the third transaction, the sale by Manhattan of the Treasury bonds.

Birnbaum held that only an actual purchaser or seller of securities may maintain an action for damages under Section 10(b). The Commission disagrees with this principle, and other courts of appeals have questioned or limited it. See, *e.g.*, *Kahan* v. *Rosenstiel*, 424 F. 2d 161 (C.A. 3), certiorari denied *sub nom. Glen Alden Corp.* v. *Kahan*, 398 U.S. 950; *Coffee* v. *Permian Corp.*, 434 F. 2d 383 (C.A. 5). The Commission believes, however, that this Court need not reach the question. Petitioner seeks only a single recovery and if the complaint states a cause of action with respect to the Treasury bonds (as to which Manhattan concededly was the seller), petitioner can recover all he is seeking under that theory. Conversely, if this claim is legally insufficient or if petitioner cannot prove fraud with respect to the sale of those bonds, he also could not recover under his two other theories.

In dismissing the portion of the complaint challenging the sale of the Treasury bonds, the court of appeals relied upon the further holding in *Birnbaum* that "Section 10(b) * * * was directed solely at that type of misrepresentation or fraud-

affirmance also was based on the majority's conclusion, Judge Hays dissenting, that as to the issue on which petitioner did have standing, there was no violation of Rule 10b–5, because the alleged fraud was not committed "in connection with the purchase or sale of any security." Save for the brief passage in note 6, *supra*, this is the only issue discussed.

The majority based this conclusion on the following reasoning: (1) the "sole object" of the fraud "was to obtain possession of Manhattan's" portfolio securities for the personal use of Bourne and Begole (App. 105a); (2) neither the purchaser nor the seller was deceived with respect to the "terms" of the sale itself (*ibid.*); (3) the fraud consisted of the failure of those in control of Manhattan to account for the proceeds, and did not affect either the securities markets, the investing public or the terms of the sale (App. 105a-107a); and (4) there was no danger that the securities sold would be overvalued on reaching the public markets (App. 107a). In short, the court of appeals found that "[t]he purity of the security transaction [here in issue] * * * [was] unsullied" (*ibid.*).

THE INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

Within the last decade the antifraud provisions of the federal securities laws, and particularly Section

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ulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs." 193 F. 2d at 464. The suggestion in *Birnbaum* that Section 10(b) does not reach fraudulent corporate mismanagement is discussed *infra*, pp. 22-25.

10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, have developed into major tools for implementing Congress' purpose "to prevent frauds in the sale" of "securities sold in interstate and foreign commerce and through the mails"[7] and "to prevent inequitable and unfair practices"[8] in connection with securities transactions. This Court noted the importance of Section 10(b) and Rule 10b-5 and the public's reliance upon them in *Securities and Exchange Commission* v. *National Securities, Inc.*, *supra*; as the Court observed, 393 U.S. at 465, these provisions "may well be the most litigated provisions in the federal securities laws * * *." A major reason for the continually increasing reliance on the federal antifraud provisions has been this Court's refusal to adopt restrictive constructions and limitations upon these and analogous antifraud provisions,[9] both in Commission enforcement actions and in private actions which serve as a "necessary supplement" to the Commission's own actions. *J.I. Case Co.* v. *Borak*, 377 U.S. 426, 432.

The Commission has a central responsibility to maintain the integrity and scope of these remedies. The rule of law established by the court below poses

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[7] Preamble, Securities Act of 1933, 48 Stat. 74.

[8] Preamble, Securities Exchange Act of 1934, 48 Stat. 881.

[9] See *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195; *Tcherepnin* v. *Knight*, 389 U.S. 332; *Securities and Exchange Commission* v. *National Securities, Inc.*, *supra*, 393 U.S. 453; *J.I. Case Co.* v. *Borak*, 377 U.S. 426; and *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375.

a serious threat to these antifraud provisions by formalistically and narrowly defining, and severely circumscribing, the scope of the securities transactions to which they apply. Cf. *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 379.

The Commission also is concerned because of the court of appeals' apparent view (App. 107a) that the availability of a remedy under state law for the alleged fraud is relevant in determining the applicability of the federal securities laws. When Congress enacted the latter laws in 1933 and 1934, it obviously was aware that many of the acts it prohibited also were illegal under state law.[10] It concluded, however, that federal regulation was necessary because the conduct involved had substantial national implications (see Section 2 of the Securities Exchange Act, 15 U.S.C. 78b), and because state law was thought to be inadequate to deal with these problems for several reasons. For example, the substantive standards of state law often were unduly restrictive, and the procedural requirements of state law often created serious obstacles to vindication of investors' rights.[11]

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[10] Sections 16 and 18 of the Securities Act of 1933 (15 U.S.C. 77p and 77r) and Section 28(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78bb(a)) all specifically recognize the regulatory overlap between state and federal law.

[11] See, *e.g.*, I Loss, *Securities Regulation* 3, 20-22, 105-107 (2d ed., 1961). The problems of state law actions are discussed generally in Comment, *The prospect for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 Yale L.J. 1120, 1123-1126 (1950); Bromberg, *Securities Law: Fraud—SEC Rule 10b-5*, Sec. 2.7 (1967).

These and similar conditions still exist. See, *e.g.*, *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195, 201 (C.A. 5), certiorari denied, 365 U.S. 814; *Matheson* v. *Armbrust*, 284 F. 2d 670, 673-674 (C.A. 9). Moreover, testimony at recent Congressional hearings reflects state concern over "the growing national problem of the infiltration of organized crime in the insurance * * * business", involving the take-over and looting of insurance companies; [12] there also have been a number of recent government suits challenging schemes to obtain control of and to loot insurance companies.[13] It would be a most unsatisfactory basis for determining the coverage of the federal securities laws to have to decide, on a case-to-case basis, whether state law would provide an adequate remedy for the particular fraud involved.

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[12] *Hearings Before the Subcommittee on Antitrust and Monopoly of the Senate Committee on the Judiciary: The Insurance Industry*, 91st Cong., 1st Sess. pt. 16, p. 9834 (1969). See, also, *id.* at 9810, 9820, 9830, 9841, 10037, 10042-10043; and pt. 15 at pp. 8817-8821, 9039, 9048.

[13] See, *e.g.*, *United States* v. *Pollack*, CR 67-178 S (N.D. Alabama), SEC Lit. Rel. Nos. 3750, 4021 and 4300, affirmed, 417 F. 2d 240 (C.A. 5) (*per curiam*); *United States* v. *Duncan*, A-110-69 CR (D. Alaska), SEC Lit. Rel. No. 4538; *United States* v. *Zimmerman*, 71-231-CR (S.D. Fla.), SEC Lit. Rel. No. 4996. Similar factual allegations have been raised in other actions. See, *e.g.*, *Securities and Exchange Commission* v. *National Securities, Inc.*, 393 U.S. 453, 455; cf. *Herpich* v. *Wallace*, 430 F. 2d 792, 798 (C.A. 5). There have been other situations in which a state insurance commissioner has sought to apply the federal securities laws to transactions of the kind here involved. See, *e.g.*, *Ottosen* v. *Kaymac Indus., Inc.*, Civ. No. 407-69 (D. Utah).

ARGUMENT

SECTION 10(b) OF THE SECURITIES EXCHANGE ACT AND RULE 10b-5 THEREUNDER PROHIBIT A FRAUDULENT SCHEME THROUGH WHICH CORPORATE INSIDERS INDUCE A CORPORATION TO SELL ITS PORTFOLIO SECURITIES BY MISREPRESENTING THAT THE PROCEEDS OF THE SALE WILL BE RETURNED TO THE CORPORATION.

A. Introduction and summary.

The central question this brief discusses is whether there exists a relationship between the January 24, 1962, sale of Manhattan's government bonds and fraudulent conduct for which any or all of the respondents can be held responsible under federal securities law. The court of appeals assumed, for purpose of a motion to dismiss, that that sale was induced by misrepresentations about the use to be made of the proceeds. The sale generated funds equal to the fair market value of the securities sold, and thus caused no injury either to the actual purchaser, or to hypothetical potential purchasers, members of the investing public. Those funds, however, were not paid to Manhattan or invested for its benefit, as had been promised. Rather, the proceeds were applied to cover the purchase of Manhattan's stock by some of the defendants. Thus, the seller, Manhattan, did not receive the value for the securities sold which it had been fraudulently assured it would receive.

The issue is whether this alleged "deceptive device or contrivance" was "use[d] or employ[ed] in connection with the purchase or sale of any security"

within the meaning of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), as implemented by Securities and Exchange Commission Rule 10b-5, 17 C.F.R. 240.10b-5.

There can be no real dispute whether this language is susceptible of a construction which would make it applicable to the assumed facts. A fraudulent promise that value will be received if securities are sold —even though that promise is not one about the value of the securities themselves—can readily be characterized as a fraud employed "in connection with" the sale of a security. Rather, the dispute is whether the language should be given such a construction.

As an initial proposition, the legislative history of Section 10(b) makes plain that neither it, nor Rule 10b-5 which implements it, are to be narrowly construed. The "in connection with" clause, in particular, "is plainly and—one must assume—intentionally the loosest linkage, in any of the federal antifraud provisions, between a proscribed act and a security transaction." Bromberg, *Securities Law: Fraud— SEC Rule 10b-5*, Sec. 7.6(1), p. 190.21 (1969). Even narrowly viewed, there is more than a loose link here between the alleged fraud and Manhattan's sale of its government bonds; that sale was directly premised on the misrepresentation made to its board of directors regarding the use to be made of the proceeds of sale. More importantly, however, the alleged scheme must be viewed as a whole, of which the sale of Manhattan's government bonds was an integral part; the court of appeals' opinion is in-

fected with a formalistic and self-contradictory disregard for the transaction as a whole. By Section 10(b), Congress sought to protect all securities investors, including corporations such as Manhattan, from all forms of securities fraud. Manhattan, as an investor, was injured by a course of events, permeated by fraud, which resulted in its loss of its government bonds without return, in any form, of the promised equal value.

B. Inducing an investor, Manhattan, to sell its securities as part of a fraudulent scheme to transfer control and strip it of its assets, upon the explicit misrepresentation that the securities would be sold and the proceeds reinvested for its benefit, constitutes a fraud perpetrated "in connection with" that sale for the purposes of Section 10(b) and Rule 10b-5.

1. Section 10(b) must be interpreted broadly to effectuate its regulatory purposes.

Although we have found no specific legislative history concerning the "in connection with" phrase, the history of Section 10(b) makes clear that that phrase should be given a broad rather than a narrow reading. The Securities Exchange Act of 1934 was enacted in response to "the speculative orgy of 1928 and 1929" [14] and a presidential call for securities "legislation [which] has teeth in it." [15] Congress sought "to protect the interests of the public against the predatory

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[14] S. Rep. No. 1455, 73d Cong., 2d Sess., 81 (1934).

[15] H.R. Rep. No. 1383, 73d Cong., 2d Sess., 2 (1934).

operations of directors, officers, and principal stockholders of corporations * * *." [16]

Necessarily, it recognized that "[s]peculation, manipulation, * * * investors' ignorance and disregard of trust relationships by those whom the law should regard as fiduciaries" were "all a single seamless web," [17] and the Act's remedial provisions would have to be equally complementary. "No one of these evils can be isolated for cure of itself alone." [18] Thus, while the Act was intended to cover "a wide field," [19] Congress understood that it itself could not, by specifying or cataloguing unlawful conduct, effectively prohibit all forms of practices which "for some purposes may be turned to illegitimate and fraudulent means." [20] Accordingly it vested "broad discretionary powers in the [Securities and Exchange Commission.]" [21]

This discretion was embodied in Section 10(b). As one of the draftsmen described an earlier version (then Section 9(c)) before the House Committee, the

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[16] S. Rep. No. 1455, 73d Cong., 2d Sess., 68 (1934).

[17] H.R. Rep. No. 1383, 73d Cong., 2d Sess., 6 (1934).

[18] *Ibid.*

[19] *Ibid.*

[20] *Id.* at 7.

[21] *Ibid.*, see also, 78 Cong. Rec. 7696 (1934) (Remarks of Rep. Rayburn). The Senate Committee viewed the Securities Act of 1933 and the Securities Exchange Act of 1934 as vesting "in the Securities and Exchange Commission jurisdiction over the source of and traffic in securities." S. Rep. No. 1455, 73d Cong., 2d Sess. 393 (1934).

section provided, in effect, "Thou shalt not devise any other cunning devices. * * * [S]ubsection (c) is a catch-all clause * * *."[22] Although representatives of the securities industry complained that this provision would give the Commission power to prohibit virtually anything,[23] Congress agreed upon the present language, which gives the Commission broad rule-making power to prohibit "*any* manipulative or deceptive device or contrivance," and omits a proposed limitation of the section solely to securities traded or listed on a national securities exchange.[24] There has been no change in Section 10(b) since its enactment.

The legislative purpose was broad; the wording of the section is correspondingly broad; and the scope of the rule adopted by the Commission to enforce it is intended to be equally broad. "It would have been difficult to frame the authority to prescribe regulations, in broader terms. Had Congress intended to limit this authority to regulations proscribing common-law fraud, it would probably have said so. We see no reason to go beyond the plain meaning of the word 'any,' indicating that the use of manipulative or deceptive devices or contrivances of whatever kind

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[22] *Hearings Before the House Committee on Interstate and Foreign Commerce on H.R. 7852 and 8720*, 73d Cong., 2d Sess. 115 (1934).

[23] *Id.* at 178, 208-209, 251, 258, 297, 305, 486; *Hearings Before the Senate Committee on Banking and Currency on S. Res. 84 (72d Cong.) and S. Res. 56 and 97 (73d Cong.)*, 73d Cong., 1st & 2d Sess. 6624, 6634, 6899, 6910, 6936-6938, 6988 (1933-1934).

[24] S. 3420, § 10(b), 73d Cong., 2d Sess. (1934) (emphasis supplied).

may be forbidden * * *." *Rekant* v. *Desser*, 425 F. 2d 872, 880 n. 15 (C.A. 5). See also, *McClure* v. *Borne Chemical Co.*, 292 F. 2d 824 (C.A. 3), certiorari denied, 368 U.S. 939.[25]

The particular function of the "in connection with" phrase is undoubtedly to restrict the application of Section 10(b) to securities transactions. Absent that phrase, the section would authorize the Commission to promulgate rules and regulations prohibiting all kinds of manipulative or deceptive devices whether or not securities transactions were involved. It does not follow, however, that the restriction is a stringent one. The "in connection with" clause "is plainly and —one must assume—intentionally the loosest linkage, in any of the federal antifraud provisions, between a proscribed act and a security transaction." Bromberg, *Securities Law: Fraud-SEC Rule 10b-5*, Sec. 7.6(1), p. 190.21 (1969). See, *e.g.*, *Herpich* v. *Wallace*, 430 F. 2d 792 (C.A. 5); *Kahan* v. *Rosenstiel*, 424 F. 2d 161, 172 (C.A. 3), certiorari denied *sub nom. Glen Alden Corp.* v. *Kahan*, 398 U.S. 950; *Hooper* v. *Mountain States Securities Corp.*, *supra*, 282 F. 2d 195 (C.A. 5), certiorari denied, 365 U.S. 814. The additional restriction placed on the rule by the court of appeals—that the fraud must affect the value which changes hands in the security trade itself—runs counter to the teaching of this Court that federal se-

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[25] The House Committee appraised the function of the Securities Exchange Act as an undertaking to "[advance] the law," by a "constant extension of the legal conception of a fiduciary relationship—a guarantee of 'straight shooting' * * *." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 5 (1934).

curities legislation, " 'enacted for the purpose of avoiding frauds,' [should be construed] not technically and restrictively, but flexibly to effectuate its remedial purposes." *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, *supra*, 375 U.S. at 195 (footnote omitted); *Tcherepnin* v. *Knight*, *supra*, 389 U.S. at 336.

2. Whether the events alleged are considered narrowly, as a misrepresentation regarding the use to be made of the proceeds of a sale of securities, or more broadly, as a scheme or course of conduct involving misrepresentation, authorization of sale by the board of directors, sale, and misappropriation of the proceeds, they constitute fraudulent conduct "in connection with" the sale of Manhattan's government bonds.

The court of appeals recognized—as, indeed, it had to—that, on the allegations of the complaint, there had been a fraud committed against Manhattan as a result of which it was deprived of assets worth $5 million. This fraud may be viewed narrowly or broadly. In its narrowest aspect, it was a typical common-law type of fraud: a misrepresentation to Manhattan's board of directors that, upon sale of the Treasury bonds, they would be replaced by securities of equal value—a representation which induced the Board to authorize the sale of the bonds. Viewing the scheme more broadly—which is the courts' customary approach under the federal securities laws— the misrepresentation and authorization were integral to a course of conduct that culminated in the misappropriation of the proceeds and that amounted to a "scheme * * * to defraud" in violation of Rule 10b-5(1) and

a "course of business" that "operat[ed] as a fraud or deceit," in violation of Rule 10b-5(3). But, however the transaction is viewed, we submit that it took place "in connection with" the sale of a security, namely, Manhattan's bonds.

a. *Misrepresentation regarding the use to be made of the proceeds of a sale of securities constitutes fraudulent conduct "in connection with" that sale.*

The court of appeals recognized that it was required to assume that Manhattan's board of directors had been deceived into making an investment decision which it would not otherwise have made. What it found significant was that the misrepresentation was not about the value of the securities to be sold, as such, but rather about the use to be made of the proceeds.

Numerous courts have held, however, that a misappropriation of funds resulting from a securities sale is within the purview of Section 10(b) and Rule 10b-5. See, *e.g.*, *Hooper* v. *Mountain States Securities Corp.*, *supra*.[26] In fact, almost since the Commission

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[26] Accord, *Securities and Exchange Commission* v. *Federal Shopping Way*, Civ. Action No. 7351 (W.D. Wash.), affirmed, 433 F. 2d 148 (C.A. 9); *Securities and Exchange Commission* v. *Bowler*, 427 F. 2d 190 (C.A. 4); *Allico National Corp.* v. *Amalgamated Meat Cutters & Butcher Workmen*, 397 F. 2d 727, 730 (C.A. 7); *Los Angeles Tr. D. & M. Exch.* v. *Securities and Exchange Commission*, 285 F. 2d 162 (C.A. 9), certiorari denied, 336 U.S. 919; *Stevens* v. *Vowell*, 343 F. 2d 374 (C.A. 10); *United States* v. *Monjar*, 147 F. 2d 916 (C.A. 3), certiorari denied, 325 U.S. 859; *Puharich* v. *Borders Electronics*

was established, application of the antifraud provisions of the Securities Act and the Securities Exchange Act to the misappropriation of investors' funds has been particularly prominent in its regulation of brokers and dealers registered with it. See, *e.g.*, *Securities and Exchange Commission* v. *Lawson*, 24 F. Supp. 360 (D. Md.).[27] Rule 10b-5(2)—which

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Co., Inc., supra, ['67-'69 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,141 (S.D.N.Y.) p. 96,651; *Goodman* v. *H. Hentz & Co.*, 265 F. Supp. 440 (N.D. Ill.); *Sinva, Inc.* v. *Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 253 F. Supp. 359, 367 (S.D. N.Y.); *Cooper* v. *North Jersey Trust Co.*, 226 F. Supp. 972, 978 (S.D. N.Y.).

[27] See also, *Securities and Exchange Commission* v. *Kelly*, ['48-'52 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 90,497 (N.D. Ill.); *Globe Securities Co., Ltd.*, 10 S.E.C. 1105; *D.S. Waddy & Co.*, 30 S.E.C. 367; *W.F. Coley & Co., 31 S.E.C.* 722; *Calvert Securities Corp.*, 35 S.E.C. 141. And see *Cooper* v. *North Jersey Trust Co., supra*, 226 F. Supp. at 978 ("such activity has been consistently viewed by the SEC as a violation of Section 10(b) and Rule 10b-5"). Compare *Norwegian Nitrogen Prods. Co.* v. *United States*, 288 U.S. 294, 315. While it could be urged that the special obligations of broker-dealers to their customers form the basis for the imposition of sanctions for conversion of a customer's securities (*see, e.g.*, Section 8 of the Securities Exchange Act, 15 U.S.C. 78h, and Rule 8c-1, thereunder, 17 C.F.R. 240.8c-1), such broker-dealer obligations are no more compelling than the obligations of insiders and controlling shareholders to their corporation. See, *e.g.*, *Pepper* v. *Litton*, 308 U.S. 295, 306-307; *Southern Pacific Co.* v. *Bogert*, 250 U.S. 483, 492; *Speed* v. *Transamerica Corp.*, 99 F. Supp. 808 (D. Del.). Moreover, in its administrative proceedings against broker-dealers growing out of the conversion of customers' securities, the Commission has generally alleged and found that such conduct constitutes a scheme to defraud and thus also violates the antifraud provisions of the federal securities laws. In light of the recent concern over brokerage house failures, it is important that no

broadly prohibits any misrepresentation or omission of a material fact—does not specify which material facts must be misrepresented or omitted before a cause of action for federal securities fraud arises; the rule speaks in terms of "any" untrue statements of material facts. By any standard, the failure of the defendants to disclose their intention to misappropriate the proceeds from the sale of Manhattan's portfolio securities and their misrepresentation that such proceeds would be used to purchase a certificate of deposit for Manhattan in a like amount were clearly material.[28] The presence of misrepresentations with respect to the investment value of the securities that are the subject of the securities transaction has never before been thought necessary, *Hooper* v. *Mountain States Securities Corp.*, *supra*, 282 F. 2d 195; *Errion* v. *Connell*, 236 F. 2d 447 (C.A. 9); *Stevens* v. *Vowell*, 343 F. 2d 374 (C.A. 10); cf. *Mills* v. *Electric Auto-Lite Co.*, *supra*, 396 U.S. at 381-382, not even by the Second Circuit. *A. T. Brod & Co.* v. *Perlow*, 375 F. 2d 393, 396-397 (C.A. 2).

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aspect of the Commission's enforcement arsenal be impaired. Cf. *Securities and Exchange Commission* v. *Charles Plohn & Co.*, 433 F. 2d 376 (C.A. 2); *Securities and Exchange Commission* v. *First Devonshire Corp.*, S.D. N.Y., 70 Civ. 3752; *Securities and Exchange Commission* v. *Robinson & Co.*, E.D. Pa., Civ. Action No. 70-2396.

[28] Materiality has been broadly defined as information a reasonable shareholder or investor "might have * * * considered important" in determining his course of action. See, *e.g.*, *Mills* v. *Electric Auto-Lite Co.*, *supra*, 396 U.S. at 384; Restatement (Second) of Torts Sec. 538(2)(a) (Tent. Draft No. 10, 1964); *Securities and Exchange Commission* v. *Texas Gulf Sulphur*, 401 F. 2d 833, 849, certiorari denied, 394 U.S. 976.

b. *The alleged sequence of events—misrepresentation, authorization of sale by the board of directors, sale, and misappropriation of proceeds—viewed as a whole demonstrates a fraud which occurred "in connection with" the sale of Manhattan's treasury bonds.*

While the previous analysis suffices to show the requisite connection, the Commission believes that the most serious deficiency in the court of appeals' opinion was in its effort to fragment the transaction by which Manhattan's securities were sold into several parts:

> [The fraudulent scheme's] sole object was to obtain possession of Manhattan's government bonds for the personal use of the perpetrators. * * * But that deception did not infect the subsequent sales transaction. With respect to the terms of the sale itself neither the purchaser nor the seller of the bonds was deceived or defrauded. * * * The fraud which harmed the plaintiff consisted of the failure of Sweeny and his associates to account for the proceeds. There is a structural difference between the sale of the corporation's bonds at a concededly fair price and the subsequent fraudulent misappropriation of the proceeds received. [App. 105a-106a].

Neither the overall scheme nor this transaction can be thus fragmented.

Contrary to the court of appeals' view, this is not the case of an individual who obtains possession of securities and then absconds. On the allegations, the deception of Manhattan continued long after possession of the bonds was obtained. Nor is this a case of a simple misappropriation of the proceeds of a sale

which, in itself, had not been fraudulently induced. Even such situations may involve a violation of the federal securities laws. But this case presents a unified scheme to defraud, with the sale of Manhattan's government securities at its center. Simply stated, the scheme was designed to pass control of Manhattan and its assets to some of the defendants at no cost to themselves, to make an improper distribution of funds to the prior owner, and to impose the cost of these activities exclusively on Manhattan.

The court's effort to chop this plan into separate fraudulent nonsecurities transactions and nonfraudulent securities transactions is analytically untenable even on its own terms. While the court speaks of a "*sole*" object of obtaining possession, which did not "infect the *subsequent* sales transaction," only a few lines later it characterizes the fraud as a failure merely "to account for the proceeds" and seeks to distinguish a sale at a fair price from a "*subsequent* fraudulent misappropriation." That the court cannot decide whether the fraud occurred before or after the "sale" is enough to show that the whole was one transaction, and that respondents' alleged fraudulent transaction cannot be denied "connection with" the sale of securities.

While Congress had no purpose to regulate transactions which comprise no more than internal corporate mismanagement, it sought to protect securities investors, including corporations such as Manhattan, from all forms of securities fraud. That corporate looting might be the motivating factor or the result

of a securities fraud is irrelevant. *McClure* v. *Borne Chemical Co., supra,* 292 F. 2d 824.[29] "The protection of one's investment once acquired is no less important than protection against acquiring an ill-advised investment." *United States* v. *Pope,* 189 F. Supp. 12, 23 (S.D. N.Y.). Enforcement actions instituted by the Commission have consistently borne out this philosophy.[30] Indeed, preserving the integrity of the securities markets was only one of the several aims of the Securities Exchange Act. With the exception of the decision below, the courts have recognized that in Section 10(b) Congress intended to prevent inequitable and unfair practices and to ensure fairness in securities transactions generally, whether conducted in the organized securities markets or face-to-face. *Matheson* v. *Armbrust,* 284 F. 2d 670, 674 (C.A. 9).[31]

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[29] See, *e.g., Rekant* v. *Desser,* 425 F. 2d 872, 878, n. 14; *Pappas* v. *Moss,* 393 F. 2d 865 (C.A. 3); *Dasho* v. *Susquehanna Corp.,* 380 F. 2d 262 (C.A. 7), certiorari denied *sub nom. Bard* v. *Dasho,* 389 U.S. 977; *Schoenbaum* v. *Firstbrook,* 405 F. 2d 215 (C.A. 2) (*en banc*), certiorari denied, *sub nom. Manley* v. *Schoenbaum,* 395 U.S. 906; *Herpich* v. *Wallace, supra.* But see, *Birnbaum* v. *Newport Steel Corp.,* 193 F. 2d 461, 464 (C.A. 2), certiorari denied, 343 U.S. 956.

[30] See, *e.g., Securities and Exchange Commission* v. *National Securities Inc., supra,* 393 U.S. at 455; *Securities and Exchange Commission* v. *Bowler, supra,* 427 F. 2d 190; *Securities and Exchange Commission* v. *Fifth Avenue Coach Lines,* 289 F. Supp. 3 (S.D.N.Y.), affirmed, 435 F. 2d 510 (C.A. 2); *Securities and Exchange Commission* v. *Parvin Dohrmann Co., et al.,* 69 Civ. 4543 (S.D.N.Y.), SEC Lit. Rel. Nos. 4441, 4459, 4475 and 4848, Securities and Exchange Commission, *Thirty-Sixth Annual Report* 109-110 (1970).

[31] See, *e.g., Herpich* v. *Wallace, supra,* 430 F. 2d at 806; *Rekant* v. *Desser, supra,* 425 F. 2d 872; *Kahan* v. *Rosenstiel,*

The Congress which recognized that "practices legitimate for some purposes may be turned to illegitimate and fraudulent means * * *"[32] could not have envisioned or countenanced such a formalistic and segmented approach as the courts below employed. See, *e.g.*, *Errion* v. *Connell*, 236 F. 2d 447, 453-454. (C.A. 9). That approach threatens to curtail the scope of fraud proscribed by the federal securities laws to narrowly-defined, definitely carved-out areas, and in the process, imperils the aspect of this legislation that has been, in large part, the key to its effectiveness—its far-reaching adaptability to unique and non-recurrent types of fraud, using as their base a securities transaction.[33]

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supra; Hooper v. *Mountain States Securities Corp., supra.* On prior occasions the Second Circuit has adopted this expansive approach to the purpose and coverage of Section 10 (b) and Rule 10b-5. See, *e.g.*, *Schoenbaum* v. *Firstbrook, supra,* 405 F. 2d 215; *Heit* v. *Weitzen,* 402 F. 2d 909 (C.A. 2), certiorari denied, 395 U.S. 903.

[32] H.R. Rep. No. 1383, 73d Cong., 2d Sess. 7 (1934).

[33] By the very language employed, the federal securities laws evidence a Congressional intent that they cover "[n]ovel or atypical" as well as "garden type variety" frauds. *A.T. Brod & Co.* v. *Perlow, supra,* 375 F. 2d at 397. As the court in *Columbia General Investment Corp.* v. *Securities and Exchange Commission,* 265 F. 2d 559, 564 (C.A. 5), noted:

> What form the deceit could or might take cannot be blueprinted. It is only certain that the measure of its skillfulness would be in proportion to the extent to which its confectors would give it the appearance of legality. One court has remarked, "The business of trading in securities is one in which opportunities for dishonesty are of constant recurrence and ever present. It engages acute, active minds, trained to quick apprehension, decision, and action." Archer v. S.E.C. 8 Cir., 1943, 133 F. 2d 795,

C. A corporate holder of securities, even though wholly owned by a single shareholder, is a "person" protected by Section 10(b) and Rule 10b-5.

Section 10(b), as implemented by Rule 10b-5 extends its protection [34] to "any person," a term defined by Section 3(a)(9) of the statute, 15 U.S.C. 78c(a)(9), to include "a corporation." Manhattan thus is protected against behavior which defrauds it "in con-

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803. This is but an elaboration of the brief, but pungent, expression of Judge Holmes for this Court in Wejss v. United States, 5 Cir., 1941, 122 F. 2d 675, 681, certiorari denied, 314 U.S. 687 * * *, that fraud is "as old as falsehood and as versable as human integrity." * * *

See also, *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc., supra,* 375 U.S. at 193 n. 41.

[34] The existence of a private right of action for violation of Section 10(b) and Rule 10b-5, which respondents do not question, is firmly established. This Court has already held that a private right of action exists under the proxy provisions of the Act. *J.I. Case Co.* v. *Borak, supra,* 377 U.S. 426. Although it has never expressly decided whether a private right of action is similarly implied for violations of Section 10(b) and Rule 10b-5, it has upheld complaints based upon that right, without discussion of the question. *Surowitz* v. *Hilton Hotels Corp.*, 383 U.S. 363; *Tcherepnin* v. *Knight, supra,* 389 U.S. 332; cf. *Securities and Exchange Commission* v. *National Securities, Inc., supra,* 393 U.S. at 471 n. 4 (dissenting opinion of Mr. Justice Harlan). Each of the ten courts of appeals that has considered the issue has held that this remedy exists. *E.g., Janigan* v. *Taylor,* 344 F. 2d 781 (C.A. 1), certiorari denied, 382 U.S. 879; *Fischman* v. *Raytheon Mfg. Co.,* 188 F. 2d 783 (C.A. 2); *McClure* v. *Borne Chemical Co., supra,* 292 F. 2d 824 (C.A. 3); *Beury* v. *Beury,* 222 F. 2d 464 (C.A. 4); *Hooper* v. *Mountain States Securities Corp., supra,* 282 F. 2d 195 (C.A. 5); *Texas Continental Life Ins. Co.* v. *Dunne,* 307 F. 2d 242 (C.A. 6); *Jordan Bldg. Corp.* v. *Doyle, O'Connor & Co.,* 401 F. 2d 47 (C.A. 7); *Myzel* v. *Fields,* 386 F. 2d 718 (C.A. 8); *Ellis* v. *Carter,* 291 F. 2d 270 (C.A. 9), dismissal affirmed, 328 F. 2d 573 (C.A. 9); *Stevens* v. *Vowell,* 343 F. 2d 374 (C.A. 10).

nection with" any sale of its securities. *Hooper* v. *Mountain States Securities Corp., supra; Pettit* v. *American Stock Exchange*, 217 F. Supp. 21 (S.D. N.Y.). The contention is nonetheless made that because Manhattan's sole shareholder was a party to the fraud, it was a self-inflicted wound; the court of appeals believed that a defrauded corporation and its injured creditors and policyholders (as distinct from its shareholders) are not persons whom the Act protects (App. 107a).

Yet Congress in enacting Section 10(b) was acutely aware of the vulnerability of creditors of and policy holders in insurance companies to securities fraud perpetrated on those companies—which even then were large securities investors.[35] Whether such frauds

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[35] See H.R. Rep. No. 1383, 73d Cong., 2d Sess. 3-4 (1934), where the House Committee, after first cataloguing the impact that frauds and improper exchange practices then prevalent had, noted that "Over 15,000,000 individuals hold insurance policies, the value of which is dependent upon the security holdings of insurance companies." See also, 78 Cong. Rec. 7867, 7869 (1934) (Remarks of Rep. Maloney); S. Rep. No. 1455, 73d Cong., 2d Sess. 5 (1934):

> Transactions in securities on organized exchanges and over-the-counter markets are affected with a national public interest. * * * [T]he current value of securities held by * * * insurance companies * * * is dependent upon market quotations and consequently the welfare of countless individuals who have a financial interest in such institutions is directly affected by activities on the exchanges.

The magnitude of investments by insurance companies in "corporate stocks and corporate and Government bonds," then recognized by Congress (H.R. Rep. No. 1383, 73d Cong., 2d Sess. 3 (1934)), is many times greater today. See 2 Securities and Exchange Commission, *Institutional Investor Study Report*, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. 778-780, 847-863 (1971).

were perpetrated by insiders or outsiders would hardly have been a matter of concern; it has long been recognized that for most purposes corporations have legal identities separate and apart from controlling shareholders and that such controlling shareholders owe a fiduciary loyalty to the corporation for the benefit of, among others, the creditors of the company; it is a loyalty which the corporation itself, or a trustee in the event of bankruptcy, may enforce. "For that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders." *Pepper* v. *Litton*, 308 U.S. 295, 306-307; *Hooper* v. *Mountain States Securities Corp.*, *supra*, 282 F. 2d at 203, 206.[36]

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[36] In *Hooper*, it was urged that in parting with $700,000 worth of treasury stock for worthless property, the corporation *qua* corporation had suffered no injury, that the only ones injured as a result of the transaction were the company's shareholders, and that the trustee (pursuing the cause of action on behalf of the bankrupt corporation) had no standing to litigate the matter for the stockholders who no longer could be deemed to have an interest in the company by virtue of its insolvency. As the court stated:

> Even in our remote position, we would be blind to all we hear and read about were we to succumb to the artificial contention that the issuance of this stock made the corporation no poorer * * *. Considering the purpose of this legislation, it would be unrealistic to say that a corporation having the capacity to acquire $700,000 worth of assets for its 700,000 shares of [treasury] stock has suffered no loss if what it gave up was $700,000 but what it got was zero. If—as we very much doubt—accountants would support any such contention as a consequence of the esoteric mysteries of the double entry system, * * *

Manhattan not only suffered an injury as a result of the fraudulent dealings in its government securities, it suffered that injury in its capacity as an investor.

> When a person who is dealing with a corporation in a securities transaction denies the corporation's directors access to material information known to him, the corporation is disabled from availing itself of an informed judgment on the part of its board regarding the merits of the transaction. In this situation the private right of action recognized under Rule 10b-5 is available as a remedy for the corporate disability. * * *

Shell v. *Hensley*, 430 F.2d 819, 827 (C.A. 5); *Herpich* v. *Wallace*, *supra* 430 F.2d at 809-810.

Enforcement of the federal securities laws has been particularly effective because it has generally been free of judicially-imposed artificial constraints on the applicability of the statutory provisions. Most of the decisions involving the provisions of those laws here under scrutiny have recognized Congress' broad aims and have followed this Court's instruction that they "make effective the Congressional purpose." *J.I. Case Co.* v. *Borak*, *supra*, 377 U.S. at 433-434. The decision of the court below, however, exalted form over substance and in so doing disregarded the caution ex-

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the law with its eye on reality would have to part company with such purists.

Id. at 203. See also *Rekant* v. *Desser*, *supra*; *Schoenbaum* v. *Firstbrook*, *supra*; *Pappas* v. *Moss*, *supra*; *Slavin* v. *Germantown Fire Ins. Co.*, 174 F. 2d 799, 805-806 (C.A. 3).

pressed by this Court that this is "an area where glib generalizations and unthinking abstractions are major occupational hazards." *Securities and Exchange Commission* v. *National Securities, Inc.*, *supra*, 393 U.S. at 465. Effective enforcement of the federal securities laws is dependent upon judicial willingness to interpret broadly the various antifraud and other statutory provisions therein. The decision below represents an unwarranted departure from this standard.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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JUNE 1971.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1971 426460 681